No. 8079

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT.

GALEN H. WELCH, Former Collector of Internal Revenue for the Sixth Collection District of California,
Defendant and Cross-Appellant,

vs.

OBISPO OIL COMPANY, a corporation,
Plaintiff and Cross-Appellee.

APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES OF AMERICA, IN AND FOR THE SOUTHERN DISTRICT OF CALIFORNIA, CENTRAL DIVISION

BRIEF FOR APPELLANT

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Independent-Review, Law Printers, 222 So. Spring St., Los Angeles. TU 1377

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BRIEF FOR APPELLANT

Opinion Below

The only previous opinion is that of the District Court (R., p. 25), which is not reported.

Jurisdiction

This appeal involves a claim for refund of income taxes for the year 1920, and is taken from the judgment of the District Court entered December 7, 1935 (R., p. 44). The petition for appeal was filed March 7, 1936. (Supp. R., p. 3). The jurisdiction of this Court is invoked by virtue of the provisions of Section 128 (a) of the *Judicial Code*, as amended by the Act of February 13, 1925.

Question Presented

Whether the District Court had jurisdiction to review the Commissioner's determination of the net income of the taxpayer after the tax liability had been determined under Sections 327 and 328 of the *Revenue Act of 1918*.

Statute Involved

Revenue Act of 1918, c. 18, 40 Stat. 1057:

> SEC. 327. That in the following cases the tax shall be determined as provided in section 328:
>
> (a) Where the Commissioner is unable to determine the invested capital as provided in section 326;
>
> (b) In the case of a foreign corporation;
>
> (c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;
>
> (d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable

year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

SEC. 328. (a) In the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representattive corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

Statement

The facts, so far as pertinent, may be summarized as follows:

The Commissioner of Internal Revenue determined the profits taxes of taxpayer for the calendar year 1920 under the provisions of Sections 327 and 328, *Revenue Act of 1918,* in the total amount of $142,765.73, or at the rate of 9.67 per cent of its income, subject to profits tax, of $1,476,330.52 for that year. The Commissioner determined the income tax of taxpayer for 1920 as follows:

Net income		$1,476,330.52
Less:		
Profits tax, Section 328	$142,765.73	
Interest on U. S. obligations, not exempt	86,134.16	
Exemption	2,000.00	230,899.89
Balance subject to 10% tax		$1,245,430.63
Amount of tax at 10%		$124,543.06

The court found that the Commissioner had overstated the net income by $40,102.44, determined as follows:

Overstatement of two items: (1) $47,461.37 representing over-valuation of liberty bonds turned over to the taxpayer by the Receiver in 1920; and (2) $159,751.56 representing proceeds from the sale of oil produced prior to March 11, 1914, together with interest during the years 1914 to 1919, inclusive, under certain agreements with the Standard Oil Company, which amounts were never in the possession or under the control of the Receiver.

Understatement of two items: (1) $40,683 representing capital expenditures in connection with litigation which were erroneously allowed as deductions; and (2) $126,427.49 representing the depletion deduction allowed by the Commissioner on oil and gas produced prior to April 20, 1920.

Net overstatement: $40,102.44; tax thereon $4,010.24.

The court concluded that it had jurisdiction of the subject matter of this action to the extent of determining the correct amount of income tax, even though the profits taxes of the taxpayer for the calendar year 1920 were determined under the special assessment provisions of the 1918 Act.

Specification of Errors to be Urged

The District Court erred:

1. In holding and deciding that it had jurisdiction of the subject matter of this action to the extent of determining the correct amount of income tax, even though the profits taxes of the taxpayer were determined under the special assessment provisions of the 1918 Act.

2. In entering judgment for the taxpayer for $4,010.24 and interest.

Argument

In *Williamsport Co. v. United States,* 277 U. S. 551, the Court concluded that the determination whether the taxpayer is entitled to the special assessment was confided by Congress to the Commissioner, and could not, in the absence of fraud or other irregularities, be challenged

in the courts. That this prohibition extended to all the factors, including that of net income, entering into the determination of the tax under special assessment, is evident from the language in *Heiner v. Diamond Alkali Co.*, 288 U. S. 502, where the Court said (pp. 506-507):

> "The parties are in agreement that the *Williamsport Wire Rope Co.* case, *supra,* precludes revision, correction, or abrogation of the Commissioner's administrative discretionary findings, where, as here, there is no allegation of fraud. On the one hand the petitioners claim that the decisions below amount to such abrogation and the making of a new finding as to the right of special assessment and a fresh computation of the tax upon revised net income; * * *
>
> "We think the petitioners' position is correct. The taxpayer's true net income was an essential factor in the problem. Until that was known the Commissioner could make no proper or satisfactory comparison with conditions prevailing in other corporations similarly circumstanced. We cannot say that if the income had been substantially less than the figure he used he would have granted special assessment under Section 327 (d). Moreover, with a different net income, he might well have had to compare the relevant conditions in respondent's business with the operating results of corporations other than those he selected on the basis of respondent's net income as found, and might have concluded that a different ratio of tax to net income was applicable in respondent's case.
>
> "The grant of special assessment and the ascertainment of the rate or ratio of tax to be applied to the net income of the taxpayer are indissolubly connected by the terms of the statute. The exercise of

the discretion in both aspects is committed to the Commissioner and to the Board of Tax Appeals upon review of his action. That discretion cannot be reviewed by the courts, nor exercised by them in place of the administrative officer designated by law. It is beyond the power of a court to usurp the Commissioner's function of finding that special assessment should be accorded, and equally so to substitute its discretion for his as to the factors to be used in computing the tax. The courts below were in error in adopting the rate chosen by the Commissioner and applying it to a net income other than that which he used in making his comparisons and arriving at the rate. The respondent's tax could only be computed in accordance with Section 301 or under Section 328. The former prescribes the elements to be considered, and error in the computation remains subject to judicial correction; the latter grants the taxpayer the benefit of discretionary action by the Commissioner, and precludes judicial revision or alteration of the computation of the tax."

The Circuit Court of Appeals for the Sixth Circuit said, in *Cleveland Automobile Co. v. United States*, 70 F. (2d) 365, certiorari denied, 293 U. S. 563, that this language must be read as a denial of jurisdiction to the courts to review the Commissioner's determination of net income in special assessment cases. See also *Joseph Joseph & Bro. Co. v. United States*, 71 F. (2d) 389 (C. C. A. 6th), certiorari denied, 293 U. S. 600.

Conclusion

The decision of the court below is erroneous and should be reversed.

Respectfully submitted,

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March, 1936.